SPECIAL REPORT

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Meaningful Corporate Tax Residence

By Omri Marian

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Tax avoidance strategies of well-known U.S. multinationals such as Apple Inc., Microsoft Corp., and Hewlett-Packard Co. have received much attention recently. Multinationals' use of foreign shell entities to shift income away from the United States is subject to scrutiny. The debate is primarily about the sourcing of income, not about the tax residence of the corporate entities involved. That is hardly surprising, because many view the tax residence of corporations as meaningless. That meaninglessness is occasionally cited to support the adoption of a territorial system of taxation, in which residence is arguably less relevant for tax outcomes.

This report summarizes some conclusions from a coming *Boston College Law Review* article in which Marian recommends a fresh look at corporate tax residence. Marian argues that the perception of meaninglessness is a result of misguided normative discussion and that it cannot be avoided by adopting a territorial system. In his report, Marian develops a functional model under which corporate tax residence tests are designed to support the policy purposes of corporate taxation, and the tests are not independently justified in normative terms. A functional approach suggests that the United States should adopt a corporate tax residence test under which domestic corporations for tax purposes are corporations whose securities are listed for public trading in the United States, or whose place of central management and control is in the United States.

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I. Introduction

The recent hoopla generated by the Senate's examination of income-shifting techniques by Apple Inc., Microsoft Corp., and Hewlett-Packard Co.[1] reemphasized the central role that foreign subsidiaries of U.S. multinationals play in tax avoidance.

For example, the Senate Homeland Security and Governmental Affairs Permanent Subcommittee on Investigations revealed that up to 30 percent of Apple's worldwide net profits between 2009 and 2011 were booked to Apple Operations International (AOI), a wholly owned subsidiary of Apple registered in Ireland.[2] Even though AOI is managed entirely from within Apple's U.S. headquarters in Cupertino, Calif., by U.S. employees of Apple,[3] AOI paid absolutely no U.S. corporate tax on those earnings.[4] The explanation for that nontaxation is rather obvious. AOI is not incorporated in the United States and as such is a foreign corporation for federal income tax purposes.[5] Therefore, AOI is not subject to U.S. corporate tax jurisdiction unless it has income that is effectively connected with a U.S. trade or business, which apparently it does not.[6]

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[1] *See* Senate Homeland Security and Governmental Affairs Committee Permanent Subcommittee on Investigations, "Offshore Profit Shifting and the U.S. Tax Code — Part 1 (Microsoft and Hewlett-Packard)" (Sept. 20, 2012) (Microsoft and HP hearing); Permanent Subcommittee on Investigations, "Offshore Profits Shifting and the U.S. Tax Code — Part 2 (Apple Inc.)" (May 21, 2013) (Apple hearing).

[2] Memorandum to Members of the Permanent Subcommittee on Investigations Re Offshore Profit Shifting and the U.S. Tax Code — Part 2 (Apple Inc.), at 23 (2013).

[3] *Id*. at 22-24.

[4] *Id*. at 34.

[5] Section 7701(a)(4), (5).

[6] *See* Lee A. Sheppard, "Apple's Tax Magic," *Tax Notes*, May 27, 2013, p. 967.

The idea that a foreign corporation wholly managed and controlled from within a physical location in the United States has no effectively connected income is a fascinating tax phenomenon, but beside the point for our purposes. I am much more intrigued by the fact that our tax code willingly accepts AOI's foreign status.

AOI was incorporated in Ireland in 1980 and never had any employees. Its only existence in Ireland is in the form of a mailbox in Cork. Because Ireland uses the central management and control (CMC) tax residence test for corporations, AOI is not considered Irish for tax purposes. And as already noted, because the United States uses the place of incorporation (POI) tax residence test, AOI is not a U.S. corporation for tax purposes. In other words, as the subcommittee notes, AOI does not exist anywhere for tax purposes. It is a figment of our imagination.

Of course, AOI is only one of many Apple subsidiaries with little or no real existence that is registered in some place other than the United States. And Apple is not alone in its use of foreign shell entities to facilitate tax avoidance.[7]

Indeed, one of the recommendations in the subcommittee's memo is to fully tax in the United States the income earned by foreign shell entities controlled and managed by U.S. parent entities. It is striking, however, that the subcommittee's memo ignores what I believe to be the underlying issue with AOI: Why do we believe it is foreign in the first place, and why shouldn't we change our tax code to make AOI what it is in substance — namely, a U.S. corporation?

It seems that when battling offshore income shifting, our attempt is almost always to target the income rather than the taxpayer. Our code contains myriad complex anti-income-shifting regimes and anti-deferral rules that are designed to support a U.S. claim to tax income earned by foreign corporations. Commentators and legislators regularly suggest (and sometime enact) ways to improve and strengthen those rules, which is what the subcommittee memo does as well.

Occasionally, bills are introduced to reform the way we define domestic corporations. But even then, the thrust of the bills is to battle tax avoidance rather than accurately define our taxing jurisdiction over corporations, which in turn cripples those bills.

The reason for this weird approach to corporate tax residence is apparently that we have no idea how to meaningfully define the tax residence of corporations. Corporate tax residence, it is argued, is a meaningless legal construct.[8]

Why is corporate tax residence viewed as meaningless, and how can we make it meaningful? In a forthcoming *Boston College Law Review* article,[9] I propose a functional approach to the problem. Namely, I recommend that corporate tax residence be defined in a way that supports the purposes for which we tax corporations to begin with. If that approach is adopted, the United States should radically reform section 7701(a)(4), which prescribes the POI test. AOI would obviously become a domestic corporation under a functional view.

Drawing from the forthcoming article, this report describes why corporate tax residence is perceived as meaningless. The reason, I argue, is that the tax residence discussion is guided by an irrelevant normative debate. I then explain that the "meaninglessness" cannot be avoided, as some have suggested, by adopting a territorial tax system. The report outlines the functional approach to corporate tax residence, which is based on the notion that corporate tax residence tests should be instrumental to the policy purposes for which we tax corporations. I conclude by questioning which residence test the United States should adopt under a functional approach.

II. Corporate Tax Residence: Meaningless?

All jurisdictions that impose tax on corporate entities determine the tax residence of those entities

[7]*See* Microsoft and HP hearing, *supra* note 1.

[8]Michael J. Graetz, "The David R. Tillinghast Lecture — Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax L. Rev*. 261, 320 (2001); Michael S. Kirsch, "Taxing Citizens in a Global Economy," 82 *N.Y.U. L. Rev*. 443, 465-467 (2007); Edward D. Kleinbard, "The Lessons of Stateless Income," 65 *Tax L. Rev*. 99, 159 (2011); David R. Tillinghast, "A Matter of Definition: 'Foreign' and 'Domestic' Taxpayers," 2 *Int'l Tax & Bus. Law*. 239, 267 (1984); Reuven S. Avi-Yonah, "Tax Competition and the Trend Toward Territoriality," University of Michigan Public Law Research Paper No. 297, 3 (2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2191251.

[9]Omri Marian, "Jurisdiction to Tax Corporations," 54 *B.C. L. Rev*. (forthcoming 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245802.

based on either formal tests, such as POI; or substantive tests, such as CMC, the place where the corporation's main economic activity is carried on,[10] and sometimes the place of the shareholders' residence.[11]

The preference for one approach over the other is guided by a normative discussion, which I argue is irrelevant.

A. Efficiency Arguments

Proponents of a formal approach support their position with efficiency arguments. Formal tests such as POI are cost-effective. Unlike the fact-intensive inquiries required by substantive tests, POI is an easy test to administer, and it provides perfect legal certainty.[12]

More importantly, however, POI is not expected to distort taxpayers' behavior in an economically significant way. Taxpayers are relatively indifferent about the place of legal incorporation. They are not, however, indifferent to real economic attributes such as infrastructure, customer base, and the quality of the labor force. Thus, the jurisdiction in which a corporation physically operates (regardless of whether it is incorporated in the same jurisdiction) has the benefit of positive externalities such as direct investment, jobs, and so on. The adoption of a substantive residency test such as CMC may encourage migration to another jurisdiction (or non-investment to begin with) depending on the factors under which tax residency is determined. For example, a CMC test may induce management migration, resulting in the loss of the positive externalities associated with having a headquarters within the jurisdiction.[13]

Thus, under efficiency-based approaches, POI is a desirable corporate tax residence test because, unlike substantive tests, it does not cause meaningful behavioral distortion.

Even if true, however, those efficiency arguments disregard the reality that corporate taxation is a completely inefficient tax regime.[14] Corporate tax is the source of multiple behavioral distortions, and it is painful to administer. In spite of that, most industrialized jurisdictions *do* tax corporations. Corporate taxation apparently serves purposes other than efficiency in revenue collection.

If the tax itself is inefficient, why should a basic qualification for imposition of the tax be efficient? If one's ideological goal is to advance efficiency, one should argue for the abolishment of corporate taxation altogether (and many do). However, adopting corporate tax residency models simply because they are efficient could undermine the ''inefficient'' purposes of corporate taxation.

For example, if our objective in taxing corporations is to tax the owners of capital — an admittedly controversial argument — the POI test completely defeats that purpose: Apple does not have to change its behavior in a meaningful way to avoid a U.S. tax burden on its shareholders. All it has to do is incorporate AOI offshore and have the income accumulate in AOI. Thus, POI is efficient in the sense that we did not distort Apple's behavior in an economically meaningful manner (Apple's headquarters is still in Cupertino, exerting positive externalities there), yet we have completely defeated the purpose of taxing Apple's shareholders on a global basis. In other words, formal tax residence tests for corporations pose the risk of defeating the policy purpose for which we seek to tax corporations in the first place.

B. 'Nexus' Arguments

On the other end of the normative spectrum, substantive corporate tax residency tests depend ''on some combination of factual elements, such as the location of the administrative headquarters or the location of the firm's center of gravity as determined by the location of the employees and assets.''[15]

Despite the multiplicity of factors considered, justifications for substantive tax residence tests share a common theme. Under the substantive approach, corporate tax residence ''requires a

[10]Such a test has been adopted in Japan, where a corporation will be considered domestic for tax purposes if, among other factors, its principal place of business is in Japan. *See* Business Operations in Japan (BNA Portfolio 969-2nd), at VII.A.2.a.

[11]For a summary of the different factual tests adopted by civil Law jurisdictions, see Luc De Broe, ''Corporate Tax Residence in Civil Law Jurisdiction,'' *Residence of Companies Under Tax Treaties and EC Law* 95 (2009).

[12]Tillinghast, *supra* note 8, at 260-261; *see* Daniel Shaviro, ''The Rising Tax-Electivity of U.S. Corporate Residence,'' 64 *Tax L. Rev*. 377 (2011); American Bar Association Section of Taxation, ''Report of the Task Force on International Tax Reform,'' 59 *Tax Law*. 649, 747 (2006).

[13]Shaviro, *supra* note 12, at 413-415; ''Tax Reform Options: International Issues, Hearing Before the U.S. S. Comm. on Finance,'' 112th Cong. (2011) (statement of James R. Hines Jr., University of Michigan).

[14]*See, e.g.*, Hines, *supra* note 13, at 11; Jane G. Gravelle, *The Economic Effects of Taxing Capital Income* 75-90 (1994); Avi-Yonah, ''Corporations, Society, and the State: A Defense of the Corporate Tax,'' 90 *Va. L. Rev*. 1193, 1197-1198 (2004); Yariv Brauner, ''The Non-Sense Tax: A Replay to New Corporate Income Tax Advocacy,'' 2008 *Mich. St. L. Rev*. 591, 592 (2008); Richard M. Bird, ''Why Tax Corporations?'' Technical Committee on Business Taxation, Working Paper 96-1, at 1 (1996).

[15]Mitchell A. Kane and Edward B. Rock, ''Corporate Taxation and International Charter Competition,'' 106 *Mich. L. Rev*. 1229, 1235 (2008).

strong nexus with a country,"[16] that "warrants, indeed, demands a high level of contribution to the public finance."[17]

These types of arguments are simply a reformulation of benefits theories under which taxation is justified as a way to finance public goods. Corporations, just like individuals, benefit from government-created public goods, and it is therefore justifiable that they pay for them. Thus, fact-intensive tests focusing on the jurisdiction of the public goods the corporation enjoys are relevant.

The implicit assumption in nexus-related arguments is that the corporate entity is the true beneficiary of government-created public goods. Under those arguments, AOI would be viewed as benefiting from some form of public good in the United States (such as infrastructure and a skilled labor force that enables AOI to be so successfully managed from Cupertino), and those benefits justify AOI paying tax in the United States.

However, contemporary corporate tax theorists generally agree that the "real entity" view of corporations has little, if any, value in explaining why and how countries tax corporations.[18] It is generally understood that corporate taxes are an instrument to reach the pockets of individuals.[19] And public finance empiricists seem to agree that "people, not corporations, pay taxes."[20] Granted, we do not really know who those people are. But we can agree, I believe, that taxes imposed on corporations are eventually borne by real people, not by some imaginary entity.

Thus, the attempt to treat corporations as human analogs for purposes of nexus determinations is misguided. If the purpose of corporate taxation is to serve as a vehicle for taxing individuals, corporate tax residence tests should be designed to ensure that the corporate tax eventually burdens the intended individuals, regardless of the nexus of the corporation. The only relevant nexus is that of the individuals we seek to tax through the taxation of corporate entities.

In sum, arguments about nexus are just as meaningless as arguments about efficiency in terms of the purposes for which we tax corporations. Neither argument provides a convincing basis for determining corporate tax residence. With this state of debate, it is hardly surprising that corporate tax residence is viewed as meaningless.

III. Territoriality Is Not the Solution

The failure to identify convincing normative bases for corporate tax residence leads some scholars to suggest we should make tax residence "unimportant" in calculating tax outcomes.[21]

One way to achieve that is to adopt a territorial system of taxation.[22] Under a territorial system, corporate tax residence is arguably less relevant for purposes of calculating tax liabilities, and the meaninglessness issue is avoided.[23] To be fair, supporters of territoriality make several other important arguments for adopting territorial taxation, such as competitiveness and efficiency. However, supporters of territoriality still frequently cite the meaninglessness of corporate tax residence as a justification for abandoning our worldwide system.

I argue that the meaninglessness of corporate tax residence does not convincingly support territorial taxation, for two reasons.

First, a territorial system would replace the taxpayer "residence" tax jurisdiction test with the concept of the source of income. Assuming that what we truly care about is the meaninglessness of legal constructs, replacing the jurisdictional concept of residence with that of source achieves very little. As several commentators have argued, the concept of source is just as meaningless as the concept of residence.[24] There is no unifying normative concept that justifies treating income as derived in one jurisdiction rather than another. I have little to add to the mounting volume of literature about the problem of sourcing income for tax purposes. But in the context of meaninglessness, all that a territorial

[16]De Broe, *supra* note 11, at 95.

[17]Robert Couzin, *Corporate Residence and International Taxation* 2 (2002).

[18]Avi-Yonah, *supra* note 14, at 1209; Steven A. Bank, "Entity Theory as Myth in the Origins of the Corporate Income Tax," 43 *Wm. & Mary L. Rev*. 447 (2001).

[19]For recent reviews of a century of literature on this issue, see, *e.g.*, Jennifer C. Gravelle, "Corporate Tax Incidence: A Review of Empirical Estimates and Analysis," Congressional Budget Office Working Paper 2011-01 (2011); Alan. J. Auerbach, "Who Bears the Corporate Tax Burden: A Review of What We Know," 20 *Tax Pol'y and Econ*. 1 (2006).

[20]Jack Mintz, "The Corporation Tax: A Survey," 16 *Fiscal Studies* 23 (1995); *see also* "Does the Tax System Support Economic Efficiency, Job Creation, and Broad-Based Economic Growth?: Hearing Before the S. Comm. on Fin.," 112th Cong. (2011) (statement of professor Michael J. Graetz, Columbia Law School, quoting Paul H. O'Neill: "corporations don't pay taxes, they collect them").

[21]Shaviro, *supra* note 12, at 395.

[22]Graetz, *supra* note 8, at 320-323; Shaviro, *supra* note 12, at 415-417.

[23]*Id.*

[24]Kleinbard, *supra* note 8, at 149; Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* 27 (2007); Lawrence Lokken, "What is This Thing Called Source," 37 *Int'l Tax J*. 25 (2011); Michael P. Devereux, "Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations," 24 *Oxford Rev. Econ. Pol'y* 698, 712-713 (2008).

system can theoretically achieve is the replacement of one meaningless legal concept with another.

The jurisprudential argument outlined above is not terribly interesting to the tax practitioner, I dare to admit. The second argument against the adoption of territoriality as a solution to the meaninglessness of corporate tax residence is more interesting: a territorial system does not avoid the meaninglessness of tax residence. Residence is probably as important in a territorial system as it is in a global system. This is because the source of income is determined by reference to the residence of corporate taxpayers in many important instances.

As any novice international tax practitioner knows, practically all jurisdictions generally determine the source of interest and dividend income by reference to the payer's residence.[25] Gains from the sale of capital assets — most importantly, the stock of a corporation — is usually sourced to the residence of the seller (which may be a corporation).[26]

Those source rules are a primary facilitator of intracompany payments, which in turn are the bread and butter of income-shifting techniques.

Importantly for our purpose, all those strategies work only because some of the corporations involved in them are foreign, while others are domestic. Corporate tax residence determination thus remains important even in source-based jurisdictions. The importance of residence is not avoided by adopting a territorial system of taxation.

In fact, all the recommendations in the subcommittee's memo touch on safeguards that are intended to prevent shifting income from domestic to foreign corporations, or to tax income earned by foreign corporations despite their foreign status.

In our context, the only effect of reforming a tax system from global to territorial is to change the function the corporate tax residence performs. While in a global system residence is an instrument to define taxing jurisdiction, in a territorial system residence is an antiavoidance instrument. I leave it to the reader to decide which is more important. But it is clear that if we adopt a territorial system, we can expect an increased incentive for U.S. multinationals to shift income to their foreign subsidiaries. In other words, residence determination is expected to play a major role under a territorial system if we choose to adopt one.

This is hardly a theoretical issue. Most territorial jurisdictions actually have corporate tax residence models far more developed than ours, specifically to combat income shifting.[27] Corporate tax residence is a real issue faced by tax policymakers in territorial jurisdictions.

In sum, if one wishes to adopt a territorial system of taxation, one could present several strong, first-order arguments in support of that system. However, the meaninglessness of corporate tax residence is not one of them. If anything, upon the adoption of a territorial system, corporate tax residence will be even more important than it is today.

IV. Corporate Tax Residence Functional Model

A. The Functional Approach in Theory

The interim conclusion is a theoretical one: The normative debate on corporate tax residence does not produce useful guidance for the formulation of corporate tax residence models. Moreover, making tax residence ''less relevant'' for purposes of calculating tax liabilities by adopting a territorial system is wishful thinking.

I have suggested that the reason for that failure is that the discussion on corporate tax residence is disengaged from the discussion of the policy justifications for the taxation of corporate entities. My proposal is therefore to force that engagement. The design of corporate tax residence models should be grounded in the notion that a corporate tax residence is nothing more than an instrument to support the policies underlying corporate tax laws.

In the forthcoming article, I develop the functional model at length and suggest possible practical responses to its theoretical difficulties. I discuss which functional residence models could respond to four major policy rationales for taxing corporations: (1) it is a proxy for taxing corporate shareholders; (2) it is a fee in consideration for the benefits of incorporation; (3) it is a regulatory device; and (4) it is a fee paid for access to liquid capital. In the article, I develop the model by analyzing each policy rationale individually. Within each analysis I include possible approaches to achieve the rationale's policy goals, and I discuss critiques of those approaches. I then discuss ways to simultaneously approach multiple policy rationales to address the reality that many jurisdictions pursue multiple policy goals in taxing corporate entities. Here, however, I focus on the model's practical application to U.S. tax laws.

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[25] *See* Yariv Brauner, ''An International Tax Regime in Crystallization,'' 56 *Tax. L. Rev*. 259, 281 (2003).

[26] Hugh A. Ault and Brian J. Arnold, *Comparative Income Taxation, A Structural Analysis* 359 (2011).

[27] For example, most EU member countries have some form of territorial or territorial-like system of taxing corporations, yet corporate tax residence has apparently developed enough there to justify a whole book dedicated to the issue: *Residence of Companies Under Tax Treaties and EC Law* (2005).

It is important to note at the outset of this analysis that I assume that the policy choice to tax corporations on a worldwide basis stands. The meaninglessness of corporate tax residence tests has been used to justify abandoning worldwide taxation in favor of territorial taxation. Because I argue that the meaninglessness does not support abandoning residence-based taxation, I assume that residence-based taxation is the preferred policy option and that territorial taxation is only a ''second best.'' Obviously, if one prefers a territorial system as a first-order policy choice, the model will have to be reexamined. It does not mean, however, that the model is useless. It means only that the function of corporate taxation will have to be redetermined and that the tax residence model may have to be revised to support the newly determined purpose of corporate taxation. For example, it would be reasonable to argue that in a territorial system corporate tax serves as a proxy to tax earnings of individuals in the territory. In that case, corporate tax residency determinations would function as a sourcing mechanism.

B. The Functional Approach in Practice

1. POI fails to support the policy purposes of U.S. corporate taxation. I start the discussion by explaining why POI, our current corporate tax residence test, fails to support contemporary policy purposes of corporate taxation in the United States.

Under a functional view of the corporate tax residence test, a POI test makes sense if the purpose for taxing corporations is to charge a fee for the benefits of incorporation. The theoretical argument would be that operating in a corporate form confers benefits, such as limited liability, transferability of interests, centralization of management, and so on. Corporate tax might be viewed as a payment in consideration for those benefits.[28] If we believe that theory, ''the jurisdiction granting the charter and investing the entity with the legal capacity to earn income . . . has the right to tax that income when it arises.''[29]

However, in the United States one can easily achieve all the benefits of incorporation with little or no corporate tax consequences. Corporate taxation in the United States, for the most part, is explicitly an elective regime.

Under the check-the-box regulations,[30] only some entities organized under U.S. laws are treated as corporations (and thus as domestic corporations) for federal income tax purposes. Other forms of business entities — most notably limited liability companies, S corporations, and partnerships — are functionally transparent for federal income tax purposes, even though they provide limited liability, centralized management, and other benefits of incorporation to their members.

A 2007 report by the Congressional Research Service notes that ''liberal rules . . . allow firms to obtain benefits of corporate status (such as limited liability) while still being taxed as unincorporated businesses.''[31] The CRS report also notes a significant rise of the share of total business income in the United States received by unincorporated businesses since 1980. Among OECD countries, the United States has almost the largest unincorporated business sector, second only to Mexico.[32]

Under those circumstances it probably makes little sense to argue that in the United States the purpose of corporate taxation is to tax the benefits of incorporation. The check-the-box regulations explicitly grant those benefits without charging anything for them. The only meaningful exception is publicly traded entities, which are treated as per se corporations and are not entitled to elect out of the corporate tax regime.

2. Which tests could support the policy purposes of U.S. corporate taxation? One could argue that a POI test is still a good tax residence test if it supports other purposes for which the United States taxes corporations. However, this argument cannot stand. To understand why, a brief survey of the possible reasons for taxing corporations in the United States is warranted.

According to U.S. tax scholars, there are at least four possible justifications (other than the benefits of incorporation) for imposing corporate taxes in the United States. I discuss each in turn and demonstrate that those purposes are not supported by the POI test. In each case I also discuss the residence test that could support the particular policy purpose.

a. U.S. corporate taxation as a means to regulate U.S. managers. According to one theory explaining the emergence of corporate taxation in the United States, corporate tax as a real-entity measure was first enacted in 1909, primarily as a regulatory

[28]Avi-Yonah, *supra* note 14, at 1205-1206; Kirsch, ''The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations,'' 24 *Va. Tax. Rev*. 475, 564-567 (2005).

[29]Tillinghast, *supra* note 8, at 259.

[30]Reg. section 301.7701-1 through -3.

[31]Jane G. Gravelle and Thomas L. Hungerford, ''Corporate Tax Reform: Issues for Congress,'' CRS, at 4 (Oct. 31, 2007).

[32]In terms of percentages as a share of total businesses income; *see* ''Small Businesses and Tax Reform: Hearing on Small Businesses and Tax Reform Before the Subcomm. on Select Revenue Measures,'' 112th Cong. (2011) (testimony of Robert Carroll of Ernst & Young LLP).

device.[33] The tax reflected negative sentiment in Congress toward managers of large-scale business entities[34] that accumulated substantial power near the end of the 19th century. It had been suggested that ''the imposition of the corporate tax will enable the government, the shareholders, and the public to obtain information that will serve as the basis for restricting such managerial abuses of power.''[35] Under that approach, the 1909 act was an attempt to restrict managerial power.[36]

There is little reason to believe that such a policy purpose is supported by POI. U.S. managers and entrepreneurs can elect out of having their income-generating corporations (such as AOI) incorporated in the United States,[37] and thus those individuals are no longer captured by POI. While there is no statistical evidence that U.S. individuals tend to prefer offshore incorporation for their parent companies,[38] there is ample evidence that U.S.-incorporated parent corporations accumulate their profits not directly, but in subsidiaries incorporated in low- or no-tax jurisdictions.[39]

The functionally logical test to adopt, assuming one seeks to regulate managers, is the CMC test, adopted by all commonwealth jurisdictions as well as many other industrialized countries. In recent years the CMC test has advanced beyond the bogus and easily manipulated ''place of board meetings'' test. The place of board meetings is no longer a decisive factor in the OECD model convention,[40] and there is some case law suggesting that the place of board meetings is no longer a sine qua non for the determination of the place of CMC.[41]

CMC is objectionable to some U.S. commentators on the ground that it may incentivize corporations to locate their headquarters offshore, resulting in the loss of the positive externalities to the United States.[42] To the best of my knowledge, no studies have examined the causative correlation between the adoption of CMC and real migration of corporate headquarters (that is, the migration of actual people and jobs). Even if that migration is real, under a functional approach it is not necessarily viewed as a problem. The functional justification for imposing tax on the expatriating corporation would be lost. Because the managers are no longer residents of the jurisdiction, the management regulation argument no longer holds, and nontaxation is therefore the correct result.

If one still maintains the concern about management expatriation, it might be because the *real* reason for taxing corporations is not to regulate managers, but some other reason. In the alternative, it could simply be that corporate taxes are set at uncompetitive rates. In that case, the correct response is to reduce corporate tax rates, not to create a loophole in the form of a dysfunctional tax residence test.

b. U.S. corporate taxation as a means to tax U.S. shareholders. A second theory explaining the inception of corporate tax in the United States is that ''corporate income tax was originally adopted as a substitute or 'proxy' for taxing corporate shareholders directly,''[43] and that the 1909 act was simply part of a continuous attempt to tax shareholders' wealth accumulated by doing business in corporate form.[44]

For the same reasons that POI fails to capture U.S. managers, it also fails to capture U.S. shareholders. In the current global environment, there is no reason for a U.S. shareholder to accumulate earnings in corporations incorporated in the United States. Rather, it is much easier (and rational from a tax planning point of view) to accumulate earnings

[33]Avi-Yonah, ''Why Was the U.S. Corporate Tax Enacted in 1909?'' *Studies in the History of Tax Law*, vol. 2, at 377 (2007); Avi-Yonah, *supra* note 14; Marjorie E. Kornhauser, ''Corporate Regulation and the Origins of the Corporate Income Tax,'' 66 *Ind. L. J.* 53 (1990).

[34]Ajay K. Mehrota, ''The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax From a Comparative Perspective,'' 11 *Theoretical Inq. L.* 497, 510 (2010); Bank, *supra* note 18, at 508-511 (2001).

[35]Avi-Yonah, ''Why Was the U.S. Corporate Tax Enacted?'' *supra* note 33, at 383.

[36]*Id.* at 382-387.

[37]And indeed, most U.S.-owned corporations in which profits have been accumulated are foreign entities; *see* Donald J. Marples and Gravelle, ''Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis,'' CRS (May 27, 2011); *see also* U.S. Permanent Subcommittee on Investigations, ''Repatriating Offshore Funds: 2004 Tax Windfall for Select Multinationals'' (Oct. 11, 2011).

[38]Eric J. Allen and Susan C. Morse, ''Tax Haven Incorporation for U.S. Headquartered Firms: No Exodus Yet,'' 66 *Nat'l Tax J.* (forthcoming 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1950760.

[39]*Supra* note 37.

[40]In the past, where the board met was seen as the decisive factor in determining the place of management, as expressed in the previous version of the OECD model tax treaty. *See* OECD Committee on Fiscal Affairs, ''Model Tax Convention on Income and on Capital,'' at 81 (July 15, 2005). However, in July 2008 the OECD neglected the place of board meeting presumption and adopted a much more nuanced (and less clear) test to determine the place of management. The decision is based on facts and circumstances. *See* OECD Committee on Fiscal Affairs, ''Model Tax Convention on Income and on Capital,'' at 77 (July 17, 2008).

(Footnote continued in next column.)

[41]*Laerstate B.V. v. Revenue and Costumes Commissioners*, [2009] UKFTT 209 (TC).

[42]Shaviro, *supra* note 12, at 414; Hines, *supra* note 13.

[43]Bank, *supra* note 18, at 452; *see also* Bank, ''Entity Theory as a Myth in the U.S. Corporate Excise Tax of 1909,'' *Studies in the History of Tax Law*, vol. 2, at 393 (2007) (hereinafter ''U.S. Corporate Excise Tax of 1909'').

[44]Bank, ''U.S. Corporate Excise Tax of 1909,'' *supra* note 43, at 395.

in a mailbox in Ireland that is respected as a foreign corporation for U.S. federal income tax purposes.

Assuming that corporate taxation is intended to reach shareholders' pockets, the logical functional residence test is a residence-of-majority-of-shareholders rule, as suggested by several commentators.[45] The main objection to that model is based on administrative concerns, such as the difficulty of applying it to publicly traded corporations.[46]

That administrative concern is overstated. The concern, presumably, is the headache caused by the potential for a traded entity to interchangeably and continuously shift from foreign to domestic tax status.[47] This issue is unlikely to pose a particularly difficult problem for U.S. tax administration, because U.S. residents own 87 percent of the aggregate value of companies traded on U.S. stock markets.[48] Although the stock of entities traded on U.S. exchanges frequently changes hands, it likely changes hands between all-U.S. parties most of the time. Assuming the determination of corporate tax residence follows the residence of the majority of shareholders, it is hard to imagine a frequent tax residency change. If, on average, 87 percent of the stock is owned by U.S. residents, more than 37 percent of the stock will have to change hands from U.S. to foreign shareholders for the corporate tax residence to be affected. Also, ownership determination could be decided on a time-average basis.

Moreover, the United States already uses legal models that look through corporations to determine beneficial ownership for tax purposes, as is done in determining whether a corporation is a controlled foreign corporation under subpart F.[49] Those models could be used to determine residence, not just beneficial ownership.

It has been argued that using the CFC ownership rules to make the corporate residence determination is the functional equivalent of eliminating deferral.[50] That is correct, but it is not a convincing argument against adopting an ownership tax residence model.

If one believes that worldwide taxation of U.S. residents is desirable, the argument against the adoption of a shareholders' ownership model amounts to an objection that the model actually achieves the desired result. That objection does not respond to the functionality of the ownership test if the purpose is to tax shareholders on a worldwide basis. At most, it argues against the purpose the ownership test intends to serve.

Finally — and most strikingly in my mind — we already have a model in our code that looks at shareholders' residence for purposes of determining corporate tax residence. I am referring, of course, to the anti-inversion rules in section 7874.

Section 7874 was added as part of the American Jobs Creation Act of 2004 to curtail expatriations (or inversions) of U.S. corporations. Section 7874 provides among other things that if, after an inversion transaction, at least 80 percent (in vote and value) of the stock of a foreign-incorporated entity (and thus otherwise a foreign entity) is owned by shareholders of the inverting U.S. corporation, the foreign corporation is treated as a domestic corporation for U.S. tax purposes.[51] Thus, an explicit model for corporate tax residence determinations based on ownership is found in the IRC, and there is no need to stray far in search of a model.

If we did want to stray afar, other jurisdictions, such as Australia and Italy, have ownership-dependent corporate tax residency models.[52] Those models may provide constructive comparative guidance and are certainly worth looking at before dismissing an ownership test as unadministrable.

c. U.S. corporate taxation as a means to alleviate agency problems in U.S. public markets. Some commentators have suggested that corporate taxation in the United States is justified as a means to reduce agency costs arising out of the nonalignment of interests between managers and shareholders in publicly traded corporations.[53]

In the absence of corporate-level tax, a corporate manager who also holds equity in the corporation is

[45]Kleinbard, *supra* note 8, at 160; Robert A. Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises," 79 *Cornell L. Rev*. 18, 70-74 (1993).

[46]Shaviro, *supra* note 12, at 415; *see also* ABA tax section, *supra* note 12, at 753.

[47]One could also raise an issue of identifying who the shareholders are. In today's tax-reporting environment this is not a terribly difficult task. Individuals who trade listed securities typically do so through accounts in financial institutions. Those institutions typically must identify and keep a record of the tax residence of the account owners. *See, e.g.*, reg. section 1.441-1(b)(2) in the context of individuals. Identification requirement also applies to foreign financial institutions. *See* sections 1471-1474.

[48]Kleinbard, *supra* note 8, at 159; Joe Wiesenthal, "Chart of the Day: Here's Who Owns the Stock Market," *Business Insider*, Nov. 30, 2012, *available at* http://www.businessinsider.com/heres-who-owns-the-stock-market-2012-11.

[49]Section 958.

[50]Shaviro, *supra* note 12, at 415.

[51]Section 7874(b).

[52]A company carrying on business in Australia will be deemed resident in Australia for tax purposes if shareholders controlling at least 50 percent of its voting power are Australian residents; in Italy, a foreign-incorporated corporation that holds a majority interest in Italian entities and is also majority-owned by Italian residents is presumed to be a resident in Italy for tax purposes.

[53]Hideki Kanda and Saul Levmore, "Taxes, Agency Costs, and the Price of Incorporation," 77 *Va. L. Rev*. 211 (1991).

likely to prefer her own tax interests when making corporate-level decisions that affect shareholder-level tax consequences. Once a tax is imposed at the entity level, it creates alignment of interests, because managers and shareholders alike have an interest in reducing entity-level tax, regardless of their individual tax interests.[54]

POI does not support that purpose. There is no requirement that an entity that is publicly traded on a U.S. exchange be incorporated in the United States. Foreign-incorporated corporations (which may or may not be subject to corporate-level tax in their home jurisdiction) that are listed for trade in the United States are not subject to the full reach of U.S. corporate tax jurisdiction. Agency costs are not necessarily alleviated in those corporations.

However, a corporate tax residency test based on the place of listing does achieve the desired result. If we accept the regulatory role of corporate taxation, it is a logical extension to treat corporations whose securities are listed in a U.S. exchange as domestic for tax purposes.

The main objection to a place-of-listing test is that it puts the local exchanges at a disadvantage by creating a tax cost for trading in those exchanges.

There are two possible responses to that concern. First, if a company is electing out of the exchange, the agency costs are no longer a concern for the jurisdiction and need not be regulated through corporate taxation.

Second, if we still care about corporate migration, the correct solution would be to lower corporate tax rates, rather than to punch loopholes in the corporate tax base by adopting dysfunctional residence tests.

d. U.S. corporate taxation as a fee for accessing U.S. public markets. A fourth alternative justification for the U.S. corporate tax suggested by scholars is that the tax is imposed as an access fee to U.S. public markets.[55] To noncontrolling shareholders, liquidity provides a significant benefit, and corporate tax can be justified as a fee on liquidity.[56]

The POI test does not support that purpose, because foreign-incorporated corporations can freely list their securities on U.S. exchanges without a need to incorporate in the United States. The place of listing, on the other hand, does support the fee-for-liquidity justification.

Here, too, arguments that a listing fee may hurt competitiveness are not convincing. Corporate managers decide where to list based on multiple considerations. They are buying into a product (the public exchange) that includes, for example, access to a specific investor pool and access to a specific regime of securities regulation. If the price the managers must pay includes corporate taxes, they will factor that into their cost analysis.

When managers decide to list in one jurisdiction and not another, it means the cost of listing in the second jurisdiction is too high. However, if one takes seriously the liquidity justification of corporate tax, it makes no sense to dismiss the place-of-listing test because it creates costs. We want it to create costs! This is the very reason to collect corporate tax under this view — to pay the jurisdiction for creating the public market. If corporate taxes discourage listing, it means that corporate taxes are set at uncompetitive rates or that the product (such as the securities regulation regime) needs improvement. Again, it does not make sense to deal with these issues by adopting a dysfunctional tax residence model.

V. Conclusion: Functional Residence of AOI

We end where we started. A significant linchpin in Apple's international tax planning is that a mailbox in Ireland with the label "Apple Operations International" on it is treated as a foreign corporation for U.S. federal income tax purposes. Regardless of whether you prefer worldwide or territorial taxation, the fact that our tax laws ask us to treat a mailbox in Ireland as a foreign corporation is an insult to intelligence.

Treating mailboxes as foreign corporations defeats any purposes that could conceivably justify the taxation of corporate entities in the United States.

If we want to reach Apple's shareholders, we can't, because their wealth accretion is treated as if it is happening in Ireland and not as a result of the deployment of capital in the United States.

If it is the managers of Apple we seek to regulate through the taxation of corporate entities, we do not achieve that, because our tax code forces us to believe that the managers of Apple's subsidiaries execute their managerial discretion in a mailbox in Ireland rather than in an office in Cupertino.

If it is access to the liquid markets we seek to tax — whether for purposes of regulating agency costs or as a liquidity fee — we miss that goal unless we believe that Apple's NASDAQ listing could not have happened if it wasn't for the existence of mailboxes in Ireland.

Of course, I have to reiterate that Apple is not at fault here. If the code allows AOI to be treated as

[54]*Id*. at 229-233.

[55]Calvin H. Johnson, "Replace the Corporate Tax With a Market Capitalization Tax," *Tax Notes*, Dec. 10, 2007, p. 1082; Rebecca S. Rudnick, "Who Should Pay the Corporate Tax in a Flat Tax World?" 39 *Case W. Res. L. Rev*. 965 (1989).

[56]Rudnick, *supra* note 55, at 1099-1103.

foreign, Apple's planning strategy is hardly surprising (and, at least to the extent of jurisdictional definitions used by Apple, seems perfectly legal).

The easy (but unnecessary) conclusion is that the United States could adopt a three-pronged residence test under which any corporation would be classified as domestic for federal income tax purposes if it is majority-owned by U.S. residents, if it is managed and controlled from within the United States, or if its securities are listed on a U.S. exchange. Under that approach, Apple, as well as all its wholly owned subsidiaries such as AOI, would be taxed as domestic corporations in the United States. That is the correct result if we believe corporate taxation is an instrument to tax specific individuals on a worldwide basis (for any of the reasons discussed above).

The three-pronged test could be simplified. U.S. publicly traded corporations are overwhelmingly owned by U.S. residents. Whether we use a place of listing test, or a place of shareholders' residence test, we would largely capture the same corporations under the definition. Under those circumstances, the place of listing test will also capture the U.S. shareholders we presumably seek to tax. Therefore, there is no need to adopt an ownership test in the current environment.

Of course, domestic publicly traded corporations may themselves hold non-publicly traded entities and channel profits through those entities, avoiding current worldwide taxation. Thus, entities controlled by corporations whose securities are listed on a U.S. exchange should also be regarded as domestic for U.S. tax purposes. As far as I am concerned, such a test alone would be a great improvement.

The issue is more elaborate in the context of regulating managers. If we are worried only about managers of publicly traded entities accumulating excessive power, the place of listing test would work as well. However, with the lack of measurable data about power accumulation in private versus public entities, the CMC test is also needed.

For example, in the absence of the CMC test, a domestically listed entity could exert its "excessive power" through the use of a non-listed affiliated entity. It is therefore necessary to ensure that the members of an affiliated group are all treated as residents in the same jurisdiction for corporate taxation to properly function as a regulation mechanism.

The bottom-line recommendation of the forthcoming *Boston College Law Review* article is that the United States adopt a test under which (1) corporations managed and controlled from the United States and (2) corporations whose securities are listed on an exchange in the United States (or corporations controlled by a corporation whose securities are listed on an exchange in the United States) will be treated as domestic corporations for federal income tax purposes.

Several bills have suggested similar tests,[57] but I do not believe they achieve the desired result. Under those bills, a foreign-incorporated corporation will be treated as domestic for tax purposes if it is managed and controlled from within the United States, *and* (1) it has $50 million or more in aggregate gross assets under management *or* (2) it is publicly traded in an established securities market. That suggestion falls short of achieving the purposes of U.S. worldwide corporate taxation. For example, if foreign-managed corporations are accessing the U.S. liquid markets, they will avoid U.S. domestic classification. This in turn means that the access to liquidity and the agency-cost-related purposes of corporate taxation are not fulfilled.

It seems that the corporate tax residence bills fall slightly short of the desired results because they are driven by the second-best set of considerations — namely, preventing tax avoidance. The bills, I believe, fail to consider the primary issue that should guide us in determining the residence of corporate entities: achieving the policy purposes of worldwide corporate taxation.

It is easy to imagine the pushback to my suggested approach from competitiveness enthusiasts. The response is twofold. If you still believe in worldwide taxation, you should support the adoption of a functional model and at the same time argue for a reduction in corporate tax rates. The system we now use for corporate residence is not a problem from the point of view of rate competitiveness. Rates can be reduced. The current system is simply a flawed instrument that defeats our worldwide system of taxation and creates, as noted by Edward D. Kleinbard, what is in effect a territorial system.[58]

If one believes in a territorial system as a policy matter — well, that is a whole new story. The dysfunctionality of corporate tax residence is not, however, a convincing argument to adopt a territorial system. If we prefer a territorial system, we would need to rethink the purposes of corporate taxation. For example, one could conceivably view corporate taxation as a proxy to territorial taxation, in which case one would have to come up with a corporate residence test that supports that purpose. I leave that inquiry for another day.

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[57]S. 268, Cut Unjustified Tax Loopholes Act, section 103, 113th Cong. (2013); S. 2075, Cut Unjustified Tax Loopholes Act, section 103, 113th Cong. (2012); H.R. 62, International Tax Competitiveness Act of 2011, section 2, 112th Cong. (2011); S. 1346, Stop the Tax-Haven Abuse Act, section 103, 112th Cong. (2011).

[58]Kleinbard, *supra* note 8, at 700.